

Sailing uncharted waters – for how long? On transitional post-Brexit trade arrangements

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On 6 December 2016, [Michel Barnier](#), the Commission's Chief Negotiator for Brexit, stated that the EU is entering uncharted waters in its negotiations with the UK. At the same time, he made clear that this journey will not be a long one; although Article 50 TEU provides for a two-year negotiation period ahead of the UK's withdrawal, the time effectively available for talks will be shorter than that. According to Barnier, less than 18 months can be devoted to negotiations, in particular because the Council and the European Parliament will need time to approve the outcome.

As the exit agreement will most likely not determine the future trade relations between the remaining 27 EU member states (the **EU-27**) and the UK in detail, separate agreements for the trade in goods and services will have to follow. Once the exit agreement comes into effect, the UK may find itself in one of three potential situations:

(i) **The one step model**: the UK and the EU-27 negotiate a new trade agreement within the exit agreement negotiation period, or the negotiation period is extended by unanimous agreement until a new trade agreement is agreed and ratified. Given the complexity of a trade deal, this option seems fairly unlikely (e.g., the CETA negotiations between the EU and Canada took more than six years). In March 2016 the [British government](#) noted that it would take up to a decade or more to reach a new agreement with the EU-27 and to replace existing trade deals with other, non-EU countries.

(ii) **The two step model**, without transitional arrangements: the exit agreement comes into effect before a new trade agreement has been reached and no transitional arrangements are provided for. The relationship between the UK and the EU-27 would then be governed by WTO law for the transitional period between exit and the entry into force of the new trade agreement. For example, the trade in goods between the UK and the EU-27 would be subject to tariffs and the trade in services would be covered by the GATS regime, which does not automatically grant rights of establishment for firms and branches, freedom to provide cross-border services or free movement of workers.

To avoid these consequences, several leaders, including the governor of the Bank of England [Mark Carney](#), have urged the UK government to seek transitional arrangements with the EU-27. In a response to such demands, the UK chancellor [Philip Hammond](#) told members of the British parliament that the government would likely seek a transitional deal to help smooth the Brexit process and avoid disruption that could risk Britain's "financial stability". The so-called Great Repeal Bill is also stated to grandfather EU law into the UK on the date of exit, in an attempt to minimise disruption on businesses (to the extent possible) from the UK side. In addition, the parliament's Treasury Select Committee has [called for written submissions](#) on transitional arrangements.

(iii) Against this background, **the three step model** becomes more likely. In this scenario, the exit agreement comes into effect before a new trade agreement has been reached, but transitional arrangements between the UK and EU preserve some degree of free trade in goods and services while the new trade agreement is being negotiated. The UK Prime Minister Theresa May expressed her support for the use of transitional arrangements during her [speech on 17 January 2017](#) setting out the UK government's negotiation objectives for exiting the EU, but made clear that the UK would not be seeking "some form of unlimited transitional status". May stated that the UK government aimed to reach an agreement about future UK/EU relations by the time the two-year Article 50 process has concluded to avoid a "*disruptive cliff-edge*". Such an agreement would have a sector-specific phased process of implementation, with UK/EU relations relying on negotiated transitional measures in the meantime.

A transitional arrangement does not mean that the UK will stay in the EU during the transition, as Carney also made clear in a [parliamentary hearing](#) (although a transition with the UK remaining within the EU could be agreed within the terms of Article 50, namely by extending the two year period until the new trade agreement is in force – i.e. the one step model). The scope, terms and duration of the transitional arrangements will themselves need to be negotiated and ratified by all relevant parties. Given the period that might elapse between exit and the new trade agreement, the freedoms provided for, as well as any financial arrangements of, the transition agreement will themselves be controversial.

A transitional arrangement would need to be in line with WTO law. Whilst there are a wide variety of potential transition models, a core issue will be alignment on WTO rules relating to goods and services. Alignment on these rules could be achieved in a variety of ways including:

- the EU-27 and the UK could agree to continue their customs union as it currently stands, until a new trade agreement enters into force; or
- an interim agreement can bridge the gap if the EU-27 and the UK cannot, or do not wish to, maintain a full customs union immediately post-Brexit.

The transitional agreement would cover a range of relationships between the UK and the EU-27. Below, the focus will be on goods and services aspects of a transitional arrangement under WTO rules on the basis that, firstly, the transitional arrangement continues the existing free movement of goods and services between the UK and the EU-27 and, secondly, on the basis that the transitional agreement provides a new, albeit transitional, trade regime between the UK and the EU-27. The scope of the transitional agreement will likely itself become a significant political (and legal) issue in the overall negotiations.

Transitional Arrangement on existing terms

Whilst there may be various reasons for perpetuating the EU regime on the free movement of goods and services between the UK and the EU-27 during the transitional period, the simplest method of achieving that result would be to operate the one step model. The below assumes that, notably for other reasons, a transitional arrangement is put in place and that it replicates the existing EU free movement of goods and services.

Trade in goods

The EU member states, including the UK, are currently members of the EU customs union (**CU**), a preferential trade agreement permitted under Article XXIV(5) GATT. Parties to the CU are permitted to deviate from the non-discrimination obligations of WTO law to grant preferential treatment to the goods of other CU parties over the goods of other WTO members.

The criteria under GATT for a CU comprise an external, an internal and a procedural requirement:

(i) **Externally**, duties and other regulations of commerce, such as import quotas, imposed by the CU with respect to trade with other WTO members outside the CU must not be, on the whole, higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the adoption of the CU. Moreover, these duties and other trade regulations have to be close to identical among the members of the CU.

(ii) **Internally**, the CU must liberalise “*substantially all the trade*” between the CU parties and substantially the same duties and other regulations of commerce must be applied by each of the members of the CU to the trade of territories not included in the CU. The requirement for “*substantially all the trade*” to be liberalised is generally considered to contain a qualitative (i.e. that no major sector of the economy can be excluded) and quantitative aspect (i.e. that a significant percentage of trade must be covered) but no specific definition has been agreed. However, it should be noted that the current EU single market goes beyond the requirements of Article XXIV(5) GATT. For example, a CU does not require the free movement of persons or capital.

(iii) With regard to due **process**, the CU must be notified to the other WTO members “*promptly*”.

If these requirements continue to be met, the UK and the EU may agree to form a new CU (i.e. the transitional arrangement) between the UK and EU-27. This CU can continue until such time as the negotiation of a new trade agreement is completed. Even if the transitional arrangement entails some limited modifications or restrictions to the terms of trade between the UK and EU, the CU can still be maintained under GATT provided that substantially all the trade between the UK and EU continues to be liberalised. If these requirements are not met, the relationship between the UK and the EU-27 would be governed by general WTO law for the transitional period as in the two step model above.

Trade in services

The EU member states are currently also parties to an Economic Integration Agreement (**EIA**), permitting the liberalisation of trade in services between the EIA members on more favourable terms than those available to other WTO members (Article V GATS).

It is strongly arguable that it would be open to the UK and the EU-27 to agree, in the transitional arrangements, to continue an EIA on their existing terms, until such time as new trade arrangements have been negotiated. An EIA may be allowed to continue even if some limitations on the free trade in services were imposed immediately post-exit from the EU, provided that the limitations did not prevent the basic criteria for an EIA being met. These basic criteria include that any such changes do not make access for services from other WTO members more onerous, and that there continues to be substantial sectoral coverage, the absence or elimination of substantially all discrimination between the EIA members and no mode of service supply is a priori excluded from free movement.

Transitional Arrangement on new terms

Even though the most pragmatic and easiest way would be to continue the existing trade terms between the EU-27 and the UK they may not be able to, or may not wish to, maintain the EU rules on free movement of goods and services, including the CU and EIA, under substantially the same, current terms.

Trade in goods

In this case, Article XXIV(5) GATT also permits “*the adoption of an interim agreement necessary for the formation of a customs union or of a free trade area*”. The interim agreement must at least satisfy the external requirement as above. Moreover, two key conditions apply specifically to interim agreements:

(i) The interim agreement must include a plan and schedule for the formation of a full CU or FTA within a “*reasonable length of time*” (Article XXIV (5)(b) GATT).

- WTO guidance on the interpretation of Article XXIV (5) GATT (the **Understanding**) states that a “*reasonable length of time*” should only exceed 10 years in exceptional circumstances and that if a longer period is required a full explanation must be provided to the Council for Trade in Goods. State practice, however, shows that implementation periods of 12 years or longer are common. For example, the US-Chile and EC-Jordan free trade agreements both provide for a 12 year period.
- The required plan should set out precisely which products are to be liberalised, by how much and by when. Therefore a substantial level of specificity regarding the final CU or FTA is necessary, which may be difficult in the context of an interim agreement used for negotiation purposes, rather than for the phased introduction of a CU or FTA for which these provisions were designed.

(ii) The interim agreement must be notified to the other WTO members, including a full listing of each party’s preferential duties to be applied over the transitional period.

Article XXIV(7)(b) GATT provides that if other WTO members find that an interim agreement is not likely to result in the formation of a CU or a FTA within the period contemplated by the parties to the agreement, or that such a period is not a reasonable one, the Council on Trade in Goods may make recommendations to this effect. The parties to the interim agreement are obligated not to maintain or put into force the interim agreement if they are

not prepared to modify it in accordance with such recommendations. In order to circumvent the possibility of such recommendations being made, WTO members prefer to notify agreements which will come into effect at a future time as full CU/FTA agreements, rather than interim agreements (e.g. the US-Chile agreement was notified as establishing an FTA despite its 10 year transitional period).

Trade in services

GATS does not explicitly refer to “*interim*” agreements regarding the trade in services. However, the EIA provisions of Article V GATS in many respects mirror Article XXIV(5) GATT, including the inclusion of a “*reasonable time-frame*” for implementation, which raises the possibility of a GATT-style interim agreement for services.

Therefore, Article V GATS requires that “*substantially all discrimination*” be eliminated or prohibited “*at the entry into force of [the EIA] or on the basis of a reasonable time-frame*”. WTO members’ discussions within the Committee on Regional Trade Agreements suggest that this may mean 5 to 10 years. It is also possible that the general practice of states in relation to the trade in goods will be considered, granting states a time period of up to, or exceeding, 10 years.

Moreover, the interim agreement would have to achieve substantial sectoral coverage. According to an explanatory footnote to Article V(1)(a) GATS, substantial sectoral coverage refers to the number of sectors, the volume of trade affected and the modes of supply. These modes include, inter alia, the supply of a service from the territory of one Member into the territory of any other Member and the supply of a service through the presence of natural persons representing a service supplier from one Member in the territory of any other Member. Therefore, an interim agreement is required to permit the free movement of persons to a certain extent. However, this free movement is limited to the supply of services and is not as far reaching as the current EU free labour-market.

Furthermore, *Wolfrum, Stoll and Feinäugle* (WTO – Trade in Services, 2008) have suggested that the requirement of substantial sectoral coverage is based on the concept of “*substantially all the trade*” in Article XXIV(8) GATT and that only one or two of the sectors set out in the services sectoral classification list may be excluded if the coverage requirement is to be met. The relative importance of the sector in terms of international exchange is also relevant and it has been argued during Committee on Regional Trade Agreement meetings that the exclusion of “*major sectors*” would prevent the EIA in services from passing the substantial sectoral coverage test. However, state practice shows that excluding some sectors, e.g. financial services, is tolerated and is even common practice (e.g. the exclusion of financial services from the Korea-Chile FTA and Trans-Pacific CEPA). Yet, if an interim agreement between the UK and the EU-27 covered too limited a range of sectors, it would likely fail to qualify as an EIA.

Conclusion

Given the short timeframe for negotiating an exit agreement, the UK and the EU-27 may not be able to agree on new terms for their future trade relations before the UK’s formal exit from the EU takes effect. Consequently, many experts are pushing for a transitional arrangement. WTO law on goods and services accepts interim agreements as long as they serve to phase-in a liberalisation – compared to the general worldwide status quo – of substantially all the trade in goods and services within a reasonable length of time (approx. 10 years). Moreover, there must not be, in general, higher obstacles to trade with WTO members outside of the transitional agreement than prior to the adoption of such an agreement. However, the maintenance of the current level of economic integration between the UK and EU-27 is not required. Neither would the WTO require the UK to remain a member of the European Economic Area. Continuing the present CU/EIA between the UK and the EU-27 for an interim period until a new deal has been struck offers a more pragmatic solution than entering into a completely new interim agreement. However, it remains to be seen whether this solution is politically palatable.

SUGGESTED CITATION Voland, Thomas: *Sailing uncharted waters – for how long? On transitional post-Brexit trade arrangements*, *VerfBlog*, 2017/1/25, <http://verfassungsblog.de/sailing-uncharted-waters-for-how-long-on-transitional-post-brexit-trade-arrangements/>.